

**The Internal Revenue Service Has Made Some
Progress, but Significant Improvements Are
Still Needed to Reduce Errors in Manual
Interest Calculations**

December 2001

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

December 19, 2001

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Has
Made Some Progress, but Significant Improvements Are Still
Needed to Reduce Errors in Manual Interest Calculations
(#200030034)

The report presents the results of our review of processing manual interest calculations on business taxpayer accounts. The overall objective of this review was to determine if the Internal Revenue Service (IRS) was achieving its goal of reducing the high number of erroneous restricted interest¹ assessments made by its employees.

In 1993, the IRS Inspection Service (now the Treasury Inspector General for Tax Administration) reported² that 40 percent of the tax accounts it reviewed either contained errors in interest amounts computed by IRS employees or were unnecessarily restricted from automated computations. In 1994, in accordance with the Federal Managers' Financial Integrity Act,³ the IRS reported this issue as a material weakness in its internal control system. As a result, the IRS established a goal to reduce its high number of erroneous restricted interest assessments.

In our present review, we found that while the IRS has achieved some success in increasing the automation of interest calculations, overall, the IRS' actions taken to address the material weakness in its controls over the calculation of restricted interest

¹ Interest on most taxpayers' accounts is calculated automatically by IRS computers. However, IRS employees manually calculate interest on some accounts because the computer is not programmed to apply numerous changes in laws, regulations, and policies. The IRS refers to this as "restricted interest."

² *Follow-up Review of the Use of Restricted Interest on Taxpayer Accounts* (Reference Number 040501, dated November 1, 1993).

³ 31 U.S.C. §§ 1105, 1113, and 3512 (1994 & Supp. IV 1998).

have not been effective. From our review of a statistical sample of 380 restricted interest cases, 44 percent contained errors in interest amounts computed by IRS employees, were unnecessarily restricted, or both. Based on the results of our sample, we estimate that over a 5-year period, the IRS could overcharge some taxpayers over \$247 million in interest, and undercharge other taxpayers over \$145 million.

Management's Response: IRS management has agreed with our findings and is proposing a number of creative actions to address the problems identified in our report. These actions include working with the Business Systems Modernization Office to create a specific command code to be used on the IRS' Integrated Data Retrieval System (IDRS)⁴ for entering restricted interest, and to enhance the ability for IRS computers to automatically calculate interest. Their planned actions also include implementing a national quality measurement system, re-engineering interest training material, and establishing a standardized tool for performing interest calculations. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may contact Gordon C. Milbourn III, Assistant Inspector General for Audit, at (202) 622-3837.

⁴ The IDRS is an IRS computer system capable of retrieving or updating stored information. This system works in conjunction with taxpayers' account records.

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Improvements Are Still Needed to Reduce Errors in Manual Interest Calculations**

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The Internal Revenue Service Has Made Some Progress, but Significant Improvements Are Still Needed to Reduce Errors in Manual Interest Calculations

Background

Interest on most taxpayer accounts is calculated automatically by the Internal Revenue Service's (IRS) computer system. However, IRS employees manually calculate interest on some accounts because the computer system is not programmed to apply numerous changes in laws, regulations, and policies. The IRS refers to this as "restricted interest" because the computer system is restricted from making the interest computations.

Over the years, these changes have increased the number of accounts requiring restricted interest calculations, as well as the complexity of the calculations and supporting analysis. Between Calendar Year (CY) 1995 and 1999, over 198,000 business tax accounts became restricted, totaling over \$7 billion in restricted interest assessments or abatements.

These manual interest calculations, which affect assessments, abatements, and refunds on taxpayer accounts, are time-consuming and highly subject to human error. Because it is well known that the IRS makes errors in these calculations, accounting firms, law firms, and others have actively marketed consulting services to assist taxpayers in recalculating interest and filing claims for refunds of amounts incorrectly assessed. These services would likely not be offered if the IRS' error rates did not justify the resources expended by these firms to find the errors.

In 1993, the IRS Inspection Service (now the Treasury Inspector General for Tax Administration) reported¹ that 40 percent of the tax accounts included in a review it performed either contained errors in interest amounts computed by IRS employees or were unnecessarily restricted from automated computations. In 1994, in accordance with the Federal Managers' Financial Integrity Act,² the IRS reported erroneous restricted interest as a material weakness in its internal control system. Since that time, a number of actions have been proposed to help correct the problem. However, until very recently,

¹ *Follow-up Review of the Use of Restricted Interest on Taxpayer Accounts* (Reference Number 040501, dated November 1, 1993).

² 31 U.S.C. §§ 1105, 1113, and 3512 (1994 & Supp. IV 1998).

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significant actions have not taken place to reduce the error rates.

We conducted our audit from September 2000 to August 2001 in the Ogden and Cincinnati IRS Centers, and the IRS National Headquarters. The audit was conducted in accordance with *Government Auditing Standards*. We were assisted by a former IRS and private sector interest expert. Detailed information of our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Internal Revenue Service Is Not Meeting Its Goal to Reduce the Number of Erroneous Restricted Interest Assessments

Presently, the Office of Penalties and Interest in the Small Business/Self-Employed (SB/SE) Division is working on a number of actions that, if successfully implemented, could help reduce the number of erroneous interest assessments. Some of the actions planned are:

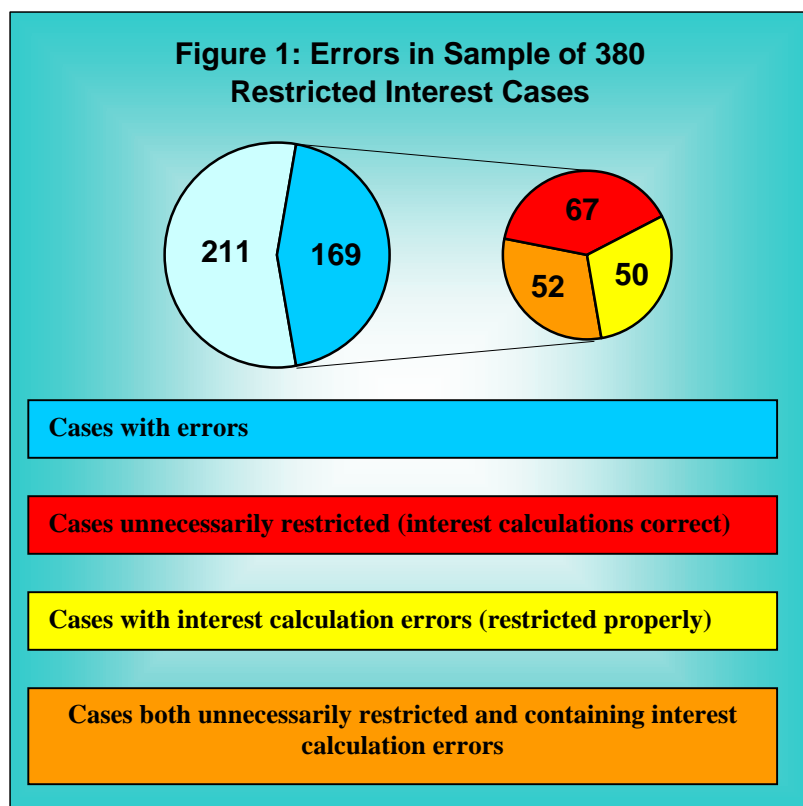
- Establishing an interest tool to be used by all IRS employees who compute interest.
- Creating a national quality review program.
- Completely rewriting and restructuring the section of the Internal Revenue Manual (IRM) dealing with interest.
- Developing additional training material and changing present training material.
- Improving the interest intranet site for use by IRS employees.

Up to now, however, the actions taken by the IRS have not effectively addressed the material weakness in its controls over the calculation of restricted interest. As a result, the IRS is not meeting its goal to reduce the number of erroneous interest assessments. In fact, from CY 1995 to 1999, the number of business accounts restricted increased by more than 4,500. Using a computer program, we identified 35,580 business accounts that became restricted in 1999 (12,792 with restricted interest transactions for zero

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dollars³ and 22,788 with restricted interest transactions containing dollar amounts).

We selected a statistical sample of 380 of those accounts with restricted interest transactions containing dollar amounts. As shown in Figure 1 below, 169 (44 percent) of these accounts contained errors in interest amounts computed by IRS employees, were unnecessarily restricted, or both.



In addition, 193 (51 percent) of the 380 cases reviewed did not provide proper documentation to support the restriction.

³ IRS employees often enter restricted interest transactions for zero dollars when they want to suppress all assessments of interest on an account.

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Accounts restricted in error

The IRS' computers are programmed to compute the proper amount of interest in most cases. However, certain transactions prohibit the computer from determining the proper interest assessment. In these instances, an IRS employee enters a code into the computer to restrict the computer from calculating the interest. After an account is restricted, employees must manually compute the interest until the account is full paid. Unnecessarily restricting accounts increases both the workload for the IRS functions that are responsible for updating interest on these accounts and the chance for calculation errors. (Calculation errors can occur when the account is initially restricted or later when the amount of interest owed is manually updated.)

Of the 380 cases reviewed, 119 (31 percent) were restricted when the computer had the ability to compute the interest on the accounts. Of these 119 accounts, 52 (44 percent) contained inaccurate interest assessments/abatements resulting in 11 taxpayers being overcharged \$749,873 and another 41 taxpayers being undercharged \$390,782. Thus, the IRS could make significant progress in its efforts to reduce the number of inaccurate interest calculations by lessening the number of accounts that are restricted unnecessarily.

The most prevalent error made by IRS employees that caused accounts to be restricted when they did not need to be was manually abating interest when tax or penalty was abated. Rather than abating the tax or penalty and letting the computer abate the appropriate interest, these employees manually abated the interest as well. Another error IRS employees often made was abating interest due to "reasonable cause." Although reasonable cause is a valid reason to abate penalties, it is not a valid reason to abate interest. In general, interest assessments may only be abated if the interest is not legally due, the interest is due to certain errors or delays by the IRS, or the interest is due to an erroneous refund. The IRM specifically states, "reasonable cause is not a basis for abating interest."

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Interest calculated incorrectly

Inherent in the IRS' mission to apply the tax law with integrity and fairness is the concept of collecting the proper amount of money from each taxpayer. If interest amounts owed by taxpayers are not calculated accurately, the IRS risks collecting too little or too much money from taxpayers whose account balances are calculated in error.

Of the 380 cases reviewed, 102 (27 percent) contained inaccurate interest amounts. These inaccuracies resulted in 32 taxpayers being overcharged more than \$825,000 and 70 taxpayers being undercharged more than \$484,000. Based on our statistical sample, we estimate some taxpayers could be overcharged over \$247 million in interest over a 5-year period and other taxpayers undercharged over \$145 million in the same period.

The calculation errors made by IRS employees included the following:

- Improper entries into the computer including prompt assessments with incorrect transaction codes, not entering "hot interest"⁴ dates, and entering bad payment dates.
- General computation errors such as not recognizing payments, interest accruals, agreement dates, or hot interest dates; using incorrect payment dates and start dates; not updating interest; etc.

Inadequate documentation

The IRM states that when manually computing interest, IRS employees should always attach the computation and the reason for the action taken. However, from our review of 380 restricted interest cases, 193 (51 percent) did not have this supporting documentation. Without this documentation, it can be difficult to determine if an account was

⁴ "Hot Interest" is an additional 2 percent added to the debit interest rate when certain corporations have underpayments which exceed \$100,000 and the balance due is not paid: (1) within 30 days of the date of notice, or (2) 30 days from the date the IRS notified the taxpayer of a proposed deficiency of tax by either a 30-day or 90-day letter.

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unnecessarily restricted or how the interest computation was made.

If an employee determines an account was unnecessarily restricted, a specific entry can be made into the computer that will cause the computer to take over the interest computations again. However, the IRM states that the entry should not be made until the original restricting document is ordered and reviewed. If the original document does not include the reason for the restriction, the employee may not be able to determine if an entry should be made to cause the computer to calculate the interest. It is also important for a copy of the interest computation to be included with the adjustment because an employee updating interest in the future might need the original computation to properly update the interest or correct the interest if it was originally computed incorrectly. This documentation can be very important in assuring the quality and effectiveness of working restricted interest cases.

Causes of accounts restricted in error, interest calculated incorrectly, and inadequate documentation

Although the calculation of interest has been classified as a material weakness for seven years, IRS employees continue to make erroneous interest assessments for several reasons.

- Interest calculations are often very complex. A single interest calculation may need to take into account multiple tax assessment amounts and dates, payment amounts and dates, penalties, accruals, specific tax laws, etc.
- Many of the IRS employees calculating interest do so only a small percentage of their work time and do not become skilled in applying the various rules associated with restricting, calculating, and documenting interest adjustments.
- Employees working restricted interest cases have not received the training they feel is necessary to prepare them to work complex interest cases. We surveyed 115 employees who worked restricted interest cases in the Ogden and Cincinnati IRS Centers; 63 percent felt they had not received adequate training to enable them

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to accurately compute interest. We found instances where even managers providing oversight or employees reviewing interest calculations made by others had little or no knowledge about calculating interest.

- Restricted interest calculations are not routinely subjected to quality review. The IRS has not mandated the quality review of these calculations. The Office of Penalties and Interest is attempting to establish a national quality review, and has taken several positive preparatory steps. However, it has yet to staff a quality review function or develop a valid sampling methodology for reviewing restricted interest cases. Not having a national quality review has likely also contributed to accounts being unnecessarily restricted and improperly documented.
- The IRS does not have standardized tools for use in calculating interest. Tools used by employees to calculate interest ranged from adding machines to various computer-based programs including Total Interest Program Software and a commercial software program called DMI Interest Net Software. The Office of Penalties and Interest hopes to make the DMI Interest Net Software the IRS' standard interest computation software by July 2002.
- Restricted interest cases are worked by many employees in many different functions within the IRS. Decisions regarding employee training, reviews of work, and tools to be used are subject to the views of various IRS managers who may have differing opinions regarding the level of commitment their function should give these matters. For example, the Office of Penalties and Interest attempted to conduct pilot quality reviews in December 1999, June 2000, and July 2000. Because there was no mandate to provide cases, the pilot did not receive full cooperation from all the offices selected for review.

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Recommendations

Many of the actions needed to address the problems with restricted interest have been planned since 1993. Because of the significance of this issue both to taxpayers and the government, the Deputy Commissioner should ensure that resolving this issue is an organizational priority. He should ensure that the Office of Penalties and Interest has the authority and resources necessary to implement the following:

1. Limit the calculation of restricted interest to centralized staffs within the various functions and locations of the IRS. Consider creating a specific command code to be used on the IRS' Integrated Data Retrieval System (IDRS)⁵ for entering restricted interest. This command code could be limited to those employees who have the necessary training and expertise to work restricted interest cases. This command code could also be used to identify cases for quality review and monitor the volumes of restricted interest cases.

Management's Response: The IRS responded that the recommendation could not be implemented with the current IDRS and Master File⁶ systems. In a subsequent discussion, the Director, Office of Penalties and Interest, indicated he will coordinate with the Associate Commissioner, Business Systems Modernization, to create a specific command code to be used on the IDRS for entering restricted interest.

2. Establish a national quality review process that includes all restricted interest cases. All restricted interest cases over a specified dollar limit should be reviewed, along with a percentage of the remaining restricted interest cases. Reviewers should be experts at computing interest and identifying whether accounts are properly restricted and documented.

⁵ The IDRS is an IRS computer system capable of retrieving or updating stored information. This system works in conjunction with taxpayers' account records.

⁶ The Master File is the main IRS computer system, containing taxpayer accounts.

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Management's Response: The Office of Penalties and Interest will implement two national Centralized Interest Quality Measurement System sites. One will be located within an SB/SE campus and the other will be located within a Wage & Investment campus.

3. Establish training that must be completed before an employee can work restricted interest cases. This training should provide significant emphasis on what accounts should or should not be restricted, and those that should be updated as the IRS further automates the calculation of interest (requiring fewer cases to be restricted). It should also emphasize the documentation procedures outlined in the IRM.

Management's Response: The Office of Penalties and Interest will "re-engineer" development and delivery of course material for the computation of interest. Input will be gathered from all functions to provide a final training product that will cover each functional area's specific interest calculation and processing activities. Additionally, Continuing Professional Education (CPE) development has just been completed for all employees who work with tax accounts. The CPE is designed to train employees on interest assessments and abatements.

4. Authorize a standard interest computation tool that would be used by all employees working restricted interest cases.

Management's Response: The Office of Penalties and Interest has purchased a commercial product called Decision Modeling Incorporated Interest Net Software that has been adopted as the standard tool for performing interest calculations.

Further Actions Are Needed to Allow the Computer to Perform More Interest Calculations

The IRS declared restricted interest a material weakness in 1994. In addressing the material weakness, the IRS outlined a number of corrective actions including: increasing the automation of interest calculations, developing a quality review process, educating the workforce, and measuring the accuracy of the program. While the IRS has made little progress in most of these areas, it has achieved some

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success in its efforts to increase the automation of interest calculations.

With the existing complexity of interest calculations, the IRS' computer system is limited in the interest computations it can perform. The Office of Penalties and Interest stated that these limitations are largely due to the fact that restricted interest requires extensive data analyses and collection that the computer system is not capable of performing. However, since 1994, the IRS has made the following enhancements to reduce the number of erroneous restricted interest assessments:

- **Non-restricting Transaction Code (TC) 340**
IRS employees restrict the computer from automatically calculating interest on a taxpayer's account by entering a TC 340 into the computer. In the past, once this transaction code was entered, the computer was restricted from calculating interest, and the interest had to be manually computed until the account was full paid. The IRS has made programming enhancements that now give IRS employees the option to manually compute interest up to the date the TC 340 was entered, and allow the computer to automatically calculate the interest thereafter.
- **Programming for Section 3305 of the IRS Restructuring and Reform Act of 1998 (RRA 98)**⁷
This section of the RRA 98 states that if the IRS does not notify a taxpayer of an amount due within 18 months of timely filing a return, interest is suspended from 1 day after the end of the notification period to 21 days after the notice is sent advising of the tax adjustment. The IRS' computer system was programmed to account for this suspension period based on comparing the date of the notice against the notification time period. As a result, accounts meeting this criterion do not need to be restricted.

⁷ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

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- **Programming for interest suspension on accounts of taxpayers participating in combat zones**

The IRS' computer system has been programmed to compute interest, allowing interest suspension on amounts owed by combat zone participants, when the computer is provided the dates the taxpayer entered and exited the combat zone. Prior to this enhancement, interest had to be restricted on all accounts where the combat zone rules applied.

The programming changes discussed above have been beneficial in reducing the number of erroneous restricted accounts. However, these efforts alone have not had a significant overall effect. Additional actions need to be taken if the IRS is to meet its goal of reducing the high number of erroneous restricted interest assessments.

Recommendation

5. The Director, Office of Penalties and Interest, in coordination with the Associate Commissioner, Business Systems Modernization, should explore all available options to provide the technology and programming necessary to allow more interest calculations to be performed by computer.

Management's Response: The Office of Penalties and Interest will coordinate with the Associate Commissioner, Business Systems Modernization, to enhance the ability to automatically calculate interest through the business systems modernization effort.

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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine if the Internal Revenue Service (IRS) was achieving its goal of reducing the high number of erroneous restricted interest assessments made by its employees.

To accomplish our objective, we did the following:

- I. Determined the number of business returns with restricted interest¹ the amount of restricted interest on the accounts, and whether the number of restrictions increased or decreased over the last 5 years.
 - A. Used a computer program to identify accounts on the IRS' Business Master File² for which interest first became restricted from Calendar Year 1995 to 1999. To do this, we identified accounts with computer Transaction Codes (TC) 340 and 341, indicating interest was restricted. We also identified accounts where restricted interest had been deleted (TC 342).
 - B. Determined the following from the results of our computer run:
 - 1. Number of accounts with restricted interest.
 - 2. Dollar amount of restricted interest on the accounts.
 - 3. Number of restrictions each year based on the date of the first restriction.
 - 4. Number of accounts with a restriction deletion.
- II. Determined if restricted interest accounts were being worked correctly.
 - A. From the results of the computer program discussed in Objective I above, selected a statistical sample of 375 zero interest amount cases and 380 non-zero interest amount cases restricted in 1999 (see Appendix IV for further information on sample selection). Reviewed 50 zero amount cases and 380 non-zero amount cases to determine if interest was properly computed on the accounts and whether the original interest restrictions were necessary.
 - B. Based on the results above, estimated for the 1999 period the total amount of overassessed and underassessed interest and the number of taxpayer accounts affected

¹ Interest on most taxpayers' accounts is calculated automatically by IRS computers. However, IRS employees manually calculate interest on some accounts because the computer is not programmed to apply numerous changes in laws, regulations, and policies. The IRS refers to this as "restricted interest."

² The Business Master File is the IRS computer system that consists of federal tax-related transactions and accounts for businesses.

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due to erroneous interest calculations. (As expected, accounts with restricted interest for zero amounts contained few calculation errors. However, it should be noted that the number of zero dollar accounts restricted in error in our review of 50 cases was very similar to the results in our sample of 380 non-zero accounts. Therefore, we included only the non-zero cases in our report.)

- III. Determined why the IRS' computer was unable to compute interest in certain conditions and whether the IRS' plans for future automation would reduce the number of restricted interest accounts.
 - A. Based on the results in Objective IIA. above, reviewed the cases where an interest restriction was necessary. Determined why the computer was unable to make the calculations.
 - B. Interviewed management responsible for the material weakness corrective actions and determined what plans were in place to automate interest calculations to reduce the number of erroneous interest assessments.
- IV. Determined what actions had been taken, and what actions were planned to assess the quality of restricted interest cases.
 - A. Interviewed management responsible for the material weakness corrective actions and determined what plans were in place to establish a quality review process for working restricted interest cases.
 - B. Determined what progress was made to implement the planned quality review process and whether the process might reduce the number of erroneous interest assessments.
 - C. Determined if cases were currently subjected to any quality review, and if not, why.
- V. Determined if instructions and procedures were adequate for working restricted interest cases.
 - A. Reviewed restricted interest Internal Revenue Manual instructions.
 - B. Reviewed any available desk procedures.
 - C. Reviewed any available training materials for working restricted interest cases.
 - D. Compared the instructions, desk procedures, and training material for consistency and accuracy in working restricted interest cases.
 - E. Interviewed employees working restricted interest cases to determine whether instructions and procedures were adequate for working the cases and whether they received adequate training to perform their duties.

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Appendix II

Major Contributors to This Report

Gordon Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Richard Dagliolo, Director

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Doug Barneck, Auditor

George Burleigh, Auditor

James E. Adkisson, Computer Specialist

Charles Pitt, former Internal Revenue Service and private sector interest expert

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Appendix III

Report Distribution List

Deputy Commissioner N:DC
Commissioner, Small Business/Self-Employed Division S
Director, Office of Penalties and Interest, Small Business/Self-Employed Division
S:C:CP:RC:P
Director, Reporting Compliance, Small Business/Self-Employed Division S:C
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaisons:
Office of the Commissioner N:DC
Commissioner, Small Business/Self-Employed Division S

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; \$247,705,560 in overassessed interest on 9,595 taxpayer accounts (see page 2).

Methodology Used to Measure the Reported Benefit:

Selection of Sample –

The Information Technology staff of the Treasury Inspector General for Tax Administration provided a database containing all business taxpayers' accounts (35,580) that became restricted in Calendar Year 1999. We stratified this population into those accounts where interest was restricted with a zero dollar amount (12,792) and those cases where interest was restricted with a dollar amount (22,788). We selected a statistically valid sample for each stratum. This sample contained 375 zero amount restricted interest cases and 380 non-zero amount restricted interest cases. Our sample was chosen based on a 95 percent confidence level, a 5 percent precision, and an expected error rate of 50 percent. The samples were chosen based on random selection. Upon selecting our samples, we obtained the source documentation for each of the restriction cases. We then reviewed the information and determined if the account was properly restricted and if the interest was assessed accurately. We ended our review of the zero amount cases after the first 50 cases because there was little dollar effect on the cases and the number of cases restricted in error was comparable to the non-zero cases. We felt we could achieve more in putting our resources in the 380 cases with a dollar amount than spending our time reviewing all 375 zero amount cases.

Sample Results –

We determined that 32 cases of the 380 reviewed had errors that caused the interest on these cases to be overassessed by \$825,967. This equals \$2,174 (\$825,967/380) per case reviewed.

Projection of Sample Results –

\$247,705,560 – Overassessed Interest on Business Tax Accounts - Using the average dollar per case of \$2,174 times the number of cases in the 1999 population (22,788) equals the estimated interest overpayment of \$49,541,112 on the 22,788 non-zero cases that became restricted in 1999. This amount was projected over 5 years.

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9,595 – Business Tax Accounts Affected - Of our sample of 380, we found 32 (8.42 percent) contained interest amounts that were overassessed. Applying the 8.42 percent occurrence rate to the 1999 population of 22,788 equals an estimated 1,919 accounts with interest overpayments. This number was projected over 5 years.

Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protection – Potential; \$145,159,560 in underassessed interest on 20,990 taxpayer accounts (see page 2).

Methodology Used to Measure the Reported Benefit:

Selection of Sample –

The same sample referred to earlier was used to determine this outcome.

Sample Results –

We determined that 70 cases of the 380 reviewed had errors that caused the interest on these cases to be underassessed by \$484,000. This equals \$1,274 (\$484,000/380) per case reviewed.

Projection of Sample Results –


\$145,159,560 – Underassessed Interest on Business Tax Accounts - Using the average dollar per case of \$1,274 times the number of cases in the 1999 population (22,788) equals the estimated interest underpayment of \$29,031,912 on the 22,788 non-zero cases that became restricted in 1999. This amount was projected over 5 years.

20,990 – Business Tax Accounts Affected - From our sample of 380, we found 70 cases (18.42 percent) contained interest amounts that were underassessed. Applying the 18.42 percent occurrence rate to the 1999 population of 22,788 equals an estimated 4,198 accounts with interest underpayments. This number was projected over 5 years.

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Appendix V

Management's Response to the Draft Report

 COMMISSIONER SMALL BUSINESS/SELF-EMPLOYED DIVISION	DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224	<div style="border: 1px solid black; padding: 5px; display: inline-block;">RECEIVED DEC 10 2001</div> DEC 03 2001
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MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *JK* Joseph G. Kehoe *Joe F. Kehoe*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report - The Internal Revenue Service Has Made Some Progress, but Significant Improvements Are Still Needed to Reduce Errors in Manual Interest Calculations

Your report addresses our efforts to reduce the high number of erroneous restricted interest assessments our employees make.

We agree we have not yet reached our goal of reducing erroneous restricted interest assessments. However, the Office of Penalties and Interest is working on a number of actions that, when implemented, will help reduce the number of erroneous interest assessments. For FY 2002, the Office of Penalties and Interest has an aggressive schedule to:

- Provide training on the use of the Automated Computation Tool (ACT) which allows for consistent and accurate interest computations;
- Establish the Centralized Interest Quality Measurement System (CIQMS) to assess the accuracy of interest computations, provide feedback on trends to personnel, and update the IRM and training material;
- Publish our restructured Interest IRM;
- Re-engineer our current training courses and provide for additional training material specific to an organization's interest processing;
- Improve our interest intranet web site.

IDENTITY OF RECOMMENDATION 1: Limit the calculation of restricted interest to centralized staffs within the various functions and locations of the IRS. Consider creating a specific command code to be used on the IRS' Integrated Data Retrieval System (IDRS) for entering restricted interest.

ASSESSMENT OF CAUSE: The Internal Revenue Service's computer system automatically calculates interest on most taxpayer accounts. Sometimes employees must manually calculate interest because our computer system cannot apply the numerous changes in laws, regulations, and policies. These manual interest computations are complex and highly subject to human error.

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2

CORRECTIVE ACTION: Based on review results, we cannot implement this recommendation with the current IDRS and Master File systems. However, our office will coordinate with the Business Systems Modernization Office (BSMO) to enhance our ability to automatically calculate interest through the BSMO modernization effort. We will implement this recommendation in conjunction with Recommendation 5 of this audit report.

IDENTITY OF RECOMMENDATION 2: Establish a national quality review process that includes all restricted interest cases.

ASSESSMENT OF CAUSE: We do not routinely perform a quality review of restricted interest calculations.

CORRECTIVE ACTION: The Office of Penalties and Interest will implement two national Centralized Interest Quality Measurement System (CIQMS) sites. We will locate one site within an SB/SE campus, which will service SB/SE, LM/SB, and TE/GE Business Operating Divisions. The second site will be located within a W&I campus and will serve only the W&I workload.

IMPLEMENTATION DATE:

- SB/SE, LM/SB, TE/GE - March 31, 2002
- W&I - April 30, 2002

IDENTITY OF RECOMMENDATION 3: Establish training that must be completed before an employee can work restricted interest cases.

ASSESSMENT OF CAUSE: Traditionally, many offices conducted interest training that was usually designed from an Examination perspective. As a result, course material was inconsistent and did not always meet the needs of the users.

CORRECTIVE ACTION: The Office of Penalties and Interest will "re-engineer" development and delivery of course material for interest computation. We will ask for input from all functions to provide a final training product that will cover each functional area's specific interest calculation and processing activities. Additionally, our office has just completed development of CPE for all employees who work with tax accounts. The CPE is designed to train employees on interest assessments and abatements.

The Internal Revenue Service Has Made Some Progress, but Significant Improvements Are Still Needed to Reduce Errors in Manual Interest Calculations

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IMPLEMENTATION DATE: We will begin the re-engineering of the interest course material by the end of FY 2002. The CPE product will be available to employees by the end of FY 2002.

IDENTITY OF RECOMMENDATION 4: Authorize a standard interest computation tool that would be used by all employees working restricted interest cases.

ASSESSMENT OF CAUSE: We do not have a standardized tool to perform interest computations. Employees use interest computation tools that range from adding machines to various computer-based programs, such as the Total Interest Program (TIPS), and the commercial software product, Tax Interest.

CORRECTIVE ACTION: The Office of Penalties and Interest has purchased the commercial product Decision Modeling Incorporated Interest Net Software (DMI), which we have adopted as the standard tool for performing interest computations. The DMI product will be utilized by the Service as the "Automated Computation Tool" (ACT).

IMPLEMENTATION DATE: "Train-the-trainer" classes are scheduled to begin in January 2002 with rollout to functional personnel by the end of FY 2002.

IDENTITY OF RECOMMENDATION 5: The Director, Office of Penalties and Interest, in coordination with the Associate Commissioner, Business Systems Modernization, should explore all available options to provide the technology and programming necessary to allow more interest calculations to be performed by computer.

ASSESSMENT OF CAUSE: Our current computer system does not have the capability to compile, assess, and store all the necessary tax law rules that will allow for complete and accurate systemic interest calculations.

CORRECTIVE ACTION: The Office of Penalties and Interest will coordinate this recommendation with the Associate Commissioner, Business Systems Modernization, to enhance our ability to automatically calculate interest. Additionally, we will incorporate the Recommendation 1 activities as part of the effort in accomplishing Recommendation 5.

IMPLEMENTATION DATE: No later than February 28, 2002, we will coordinate with the Business Systems Modernization Office (BSMO) to develop a plan under the BSMO modernization effort to enhance our ability to automatically calculate interest.

The Internal Revenue Service Has Made Some Progress, but Significant Improvements Are Still Needed to Reduce Errors in Manual Interest Calculations

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RESPONSIBLE OFFICIAL: Deputy Director, Compliance Policy

CORRECTIVE ACTION MONITORING PLAN: The appropriate functional staff will advise the Deputy Director, Compliance Policy of any delays in achieving the corrective action goals.

Please call Doug Rogers, HQ Program Manager, Small Business/Self-Employed, at (202)283-2203, if you have any questions.